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THE CONCEPT OF INCOME IN FEDERAL TAXATION

BY HENRY ROTTSCHAEFER*

THE economist's aim in defining "income" is that of developing a working tool adapted to economic analysis. The task confronting a court charged with the burden of defining it is generally, as far as its legal character is concerned, that of discovering what some person or group other than the judges themselves intended it to mean. The judicial determinations of what constitutes income as between life-tenant and remainderman, and what is income within the sixteenth amendment, have at least that formal characteristic in common.¹ The element of fiction usually present in this judicial process is enhanced when applied to a constitutional amendment in whose adoption many and widely scattered groups have participated. It was almost certain that the intention that would emerge in the process of construing the sixteenth amendment would be as much the product of judicial creation as the record of a discovered fact.² It was to be expected that economic analysis would enter into the process, but at the same time that it would not be the sole factor in it. The very fact that courts had already prior to the adoption of the sixteenth amendment determined the character of stock dividends as income or capital would be relevant to the legal problem presented by *Eisner v. Macomber*, but have practically no significance for the economist. The refinements of economic anal-

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¹*Eisner v. Macomber*, (1920) 252 U. S. 189, 40 Sup. Ct. 189, 64 L. Ed. 521. See for discussion of this problem, E. H. Warren, Taxability of Stock Dividends as Income, 33 Harv. L. Rev. 885; E. Seligman, Implications of the Stock Dividend Decision, 21 Col. L. Rev. 313; T. R. Powell, Stock Dividends, Direct Taxes, and the Sixteenth Amendment, 20 Col. L. Rev. 536.

²This is true of both the prevailing and dissenting opinions in *Eisner v. Macomber*, (1920) 252 U. S. 189, 40 Sup. Ct. 189, 64 L. Ed. 521.

ysis frequently transcend the needs involved in the problem before the courts, and might even interfere with the practical purposes of income taxation. The treatment of the question whether savings constitute income furnishes an example. There are, therefore, reasons why the legal theory of income for income tax purposes cannot be expected to conform exactly to any of the various theories advanced by economists,³ but the character of the problem makes it desirable to take these latter at least as points of departure in developing the former. However much the economists' views may lack that definiteness that is essential to exact classification of situations into those that do, and that do not, involve income, they do represent the views of those best qualified to deal with such questions. Resort to the economists' theories in evaluating the legal theory is, therefore, legitimate, particularly in so far as the courts have supported their theory by economic analysis.⁴ The subsequent discussion will proceed on that assumption.

The economist frequently finds it desirable to distinguish between social and individual income. A government that taxes income is mainly interested in how much income particular taxpayers receive during a given tax period regardless of whether the amount received by anyone of them involves a concurrent addition to social income or a mere redistribution of the social income accrued during the same or a previous tax period. The distribution to stockholders by a going concern during a given period of the net corporate earnings for the same period represents a mere redistribution of what had already become part of the social income, and the same is equally true of such corporate distributions from the net earnings of prior tax periods. The various federal income tax acts have treated such redistributions as involving the receipt of income by the stockholders, and it has been held that the sixteenth amendment does not prevent this result even where the distribution is from the net earnings accumulated by the corporation prior to its adoption.⁵ This does not

³See W. W. Hewett, *The Definition of Income and Its Application in Federal Taxation*. R. M. Haig, *The Concept of Income—Economic and Legal Aspects*, in R. M. Haig, *The Federal Income Tax*.

⁴See R. M. Haig, *The Federal Income Tax*; J. Learned Hand in *Fraser v. Comm. of Int. Rev.*, (C.C.A. 2nd Cir. 1928) 25 F. (2d) 653.

⁵*Lynch v. Hornby* (1918) 247 U. S. 339, 38 Sup. Ct. 543, 62 L. Ed. 1149. Dividends from pre March 1, 1913, surplus are no longer taxable, but, since such tax-free distributions reduce the loss and gain base on disposing of the stock, the effect of the change has been merely to defer the time when they affect the stockholder's income.

mean that every receipt by a particular taxpayer after February 28, 1913, could validly be treated as income, but only that the reason for its exclusion must be found in some other ground than that it involves a mere redistribution of what had already entered the aggregate social wealth through the door of income. The sixteenth amendment, therefore, permits Congress to adopt the individual, as distinct from the social income concept, although it undoubtedly also allows it to define income so as to reflect considerations derived from the latter theory which is in effect what happens when gifts received are excluded from gross income, whatever may have been the motive or purpose of that statutory provision. The tax Acts have been construed as embodying an individual income concept.⁶ One further preliminary remains. Economists have urged some very cogent objections to a money income concept because of the many situations in which money income varies from real income. The exigencies of taxation, however, make it easily the most practical conception, and the income tax definitions have embodied it to the practical exclusion of every other type of income concept. This does not mean that receipts of money alone are income, but that, regardless of the form in which income is received, it enters into the account with the government in the amount of its monetary equivalent. The argument in the prevailing opinion in *Eisner v. Macomber* that nothing more clearly demonstrated the capital nature of stock dividends than that it would require a conversion of capital to pay the tax seems predicated on the view that nothing is income unless available for payment of the tax in the form in which received. Since in general taxes have to be paid in money, this would indicate the adoption of a quite naive money income concept. The later cases holding dividends paid in debentures of the paying company,⁷ or in stock of other companies,⁸ to be income, show clearly that the courts have not accepted the full implications of that theory. It would, therefore, be unwarranted to conclude that the sixteenth amendment required income to be construed in

See article by T. R. Powell, *Income and Corporate Dividends*, 35 Harv. L. Rev. 363.

⁶*United States v. Phellis*, (1921) 257 U. S. 156, 42 Sup. Ct. 63, 66 L. Ed. 180.

⁷*Doerschuk v. United States*, (D.C. N.Y. 1921) 274 Fed. 739.

⁸*United States v. Phellis*, (1921) 257 U. S. 156, 42 Sup. Ct. 63, 66 L. Ed. 180; *Cullinan v. Walker*, (1923) 262 U. S. 134, 43 Sup. Ct. 495, 67 L. Ed. 906; *Marr v. United States*, (1925) 268 U. S. 536, 45 Sup. Ct. 575, 69 L. Ed. 1079.

terms of the money income concept, it is quite unlikely that any other theory will ever be acted on, although the real income theory might well secure a more equitable distribution of the tax burden especially so far as capital gains enter into taxable income.

Courts and economists are agreed that income denotes a flow of something⁹ during a period of time as distinct from a static situation as of a particular instant of time. There is considerable controversy among economists whether that "something" is comprised of usances, services, goods, or the money value of these. The adoption of the money income concept by our tax laws commits them to the last of these alternatives. The legal theory of income thus has reference to the money value of the flow of goods and services accruing to a person during a given period of time.¹⁰ It is apparent from experience that the receipt of something of value by a given person frequently involves a prior outlay of other things of value by him. The question, therefore, arises whether the constitutional theory of income requires the latter fact to be taken into account in determining such person's income in respect of that receipt. The statutory definitions have invariably recognized this factor in their provisions as to deductions from gross income. The 1913 Act, however, limited the depletion deduction in the case of mines in such manner as to result in some cases in the inclusion in the taxable net income of part of the capital value of the product of the mine. This was attacked on the ground that it produced to that extent a tax on capital as such, thus involving an unapportioned direct tax. The decision denied that the method involved a violation of the sixteenth amendment, but the reasoning of the opinion leaves the ultimate basis for the holding shrouded in almost impenetrable obscurity.¹¹ In a later case a corporation had a favorable contract for the purchase of its raw materials which had an admitted value at March 1, 1913, of X dollars. The court construed the 1916 Act as not permitting the deduction of the exhaustion of its value due to lapse of time. The taxpayer's contention that this would be invalid as a direct tax on capital was answered with the argument that

⁹What that something is, is a matter of dispute among economists. The law has, as indicated, treated it as meaning the money value of goods and services.

¹⁰The definition is made to include services to take care of such cases as those in which a person receives a salary paid in money plus living quarters; see, e.g., Reg. 69, Art. 33.

¹¹*Stanton v. Baltic Mining Co.*, (1916) 240 U. S. 103, 36 Sup. Ct. 278, 60 L. Ed. 546.

"under the sixteenth amendment the Congress had the power to require the payment of the tax without allowing any deduction for the purpose of returning to the taxpayer his entire invested capital at the expiration of the life of the property from which the income was derived."¹² The decisions warrant the inference that a gross income concept accords with the meaning of "income" in the sixteenth amendment, differing in this respect from the most generally accepted definitions of the economists. The court in its opinion in the last cited case, however, stated that "if any part of the income had been the result of a sale by the plaintiff to another of an interest in the contract itself, a different question would be presented." This intimation merely reflected the emphasis on "gain" as an element in income in *Eisner v. Macomber* and *Goodrich v. Edwards*. The definition of income in *Eisner v. Macomber* states, among other things, that it is "the gain derived from capital, from labor, or from both combined."¹³ In *Goodrich v. Edwards*¹⁴ the Supreme Court approved the government's act in confessing that there was no taxable gain in the case of a sale of a capital asset, acquired prior to March 1, 1913, if sold at less than its cost although for more than its March 1, 1913 value. The opinion shows clearly that the Court itself would have so held had it been called upon to decide that issue, its reasons were that the statute taxed gains only, that the definition of income approved by the Court in the *Macomber Case* stressed gain as an element in income, and that there was no gain where the selling price was less than original cost. The case involved only a construction of the 1916 Act, but, in view of the part played by the definition of income in *Eisner v. Macomber* in the Court's ascertainment of the meaning of "gain," there exist grounds for believing that the Court adopted its definition of "gain" as one demanded by its theory of income enunciated in the *Macomber Case*. That theory was not formulated for any particular fact situation, but has all the appearances of being intended as one of general applicability. If "gain" in the definition in *Eisner v. Macomber* has the meaning given it in *Goodrich v. Edwards*, as can with justice be argued for the reasons just stated, then the sixteenth amendment embodies

¹²Ky. Tobacco Products Co. v. Lucas, (D.C. Ky. 1925) 5 F (2d) 723.

¹³*Eisner v. Macomber*, (1920) 252 U. S. 189, 40 Sup. Ct. 189, 64 L. Ed. 521.

¹⁴(1921) 255 U. S. 527 41 Sup. Ct. 390, 65 L. Ed. 758.

a net income concept. In any event, if the view of *Goodrich v Edwards* above stated be adopted, income in the amendment emerges as a net income concept as applied to sales of capital assets other than those gradual dispositions thereof that are a normal incident of any business employing capital and which are supposed to be cared for through depreciation or depletion. The authorities, therefore, do not warrant a definitive answer to the questions whether the sixteenth amendment permits the adoption of a gross income concept or requires the adoption of a net income concept, the most that can be said is that they have permitted the former in certain situations, and justify the view that they require the latter in certain other situations. This is a rather unfortunate state of affairs since no tests have been judicially developed to determine into which category any particular situation will be put.¹⁵

The accepted definition of income as used in the sixteenth amendment stresses gain as an element therein. The idea that naturally suggests itself when the term "gain" is used in connection with economic matters is that of an increase in wealth. It might seem, therefore, that no transaction would produce taxable income unless its effect involved an increase in wealth to the particular person chargeable therewith for tax purposes. It should be stated that the question here is not whether the particular act on whose occurrence the law makes the existence of income dependent itself produces an increase in the taxpayer's wealth, but rather whether it terminates a process that has involved that result. The receipt of a salary at the end of a month, for instance, does not itself increase the recipient's wealth, it does, however, furnish a convenient moment for treating as a completed unit the process by which the recipient was increasing his wealth during such month. There are indications that this consideration sometimes influences courts to decide that particular transactions produce no income. In one case a railroad company had leased its road to an operating lessee under a lease that required the lessee to pay all taxes assessed on the lessor's income. The government assessed an additional tax on the lessor on the amount of the federal income tax paid for it by the lessee. It was held that the 1916 Act did not warrant that tax.¹⁶ The reason that was deemed conclusive

¹⁵The statutory definitions of the taxable quantity have in general followed the lines of a net income concept, and one in some respects even more favorable to the taxpayer.

against the government's contention was that the transaction involved no gain for the lessor and that the definition of income in *Eisner v. Macomber* used the word "gain." The court's conception of gain appears from the statement that the lessor "is not made richer by the tax. Its financial situation is the same as when no income tax is laid, and continues the same however high the rate of such taxation may become." Whatever may be thought of the accuracy of this analysis, which takes no account of what the lessor's financial condition would have been had it itself paid said income tax, the theory that increase in the taxpayer's wealth is essential to the existence of income is here clearly expressed. The same underlying theory is found in those decisions that hold that an annuitant has no taxable income as long as the sum of the annual payments received is less than the consideration paid for the annuity¹⁷ These decisions did not directly determine that increase in the taxpayer's wealth is a constitutional requisite to the existence of income, but some at least rely upon the definition in *Eisner v. Macomber* in support of their view. *Goodrich v. Edwards* affords another instance in which increase in wealth accruing to the person charged with the acquisition of income is deemed essential to the existence of income.

There are, however, decisions that point to a contrary conclusion. *Lynch v. Hornby*¹⁸ involved the validity of the inclusion in a stockholder's income of dividends received after the adoption of the sixteenth amendment but paid out of corporate surplus accumulated from earnings prior thereto. The facts of the case make it certain that these accumulations occurred during the period of the stockholder's ownership of his shares. His wealth had, therefore, increased by at least the amount of the taxed dividends during the period of his ownership, an increase reflected in the March 1, 1913 value of his stock. The case decided that the return to him of a part of that capital value in the form of dividends paid by a going concern could be treated as the receipt by him of income within the meaning of the sixteenth amendment. It does not decide that the stockholder would or could have been taxed with the receipt of said dividends had he

¹⁶*Boston & Me. R. v. United States*, (D.S. Mass. 1927) 23 F (2d) 343.

¹⁷*United States v. Bolster*, (C.C.A. 1st Cir. 1928) 26 F (2d) 760; *Allen v. Brandeis*, (C.C.A. 8th Cir. 1928) 29 F (2d) 363; *Warner v. Walsh*, (C.C.A. 2d Cir. 1926) 15 F (2d) 367.

¹⁸(1918) 247 U. S. 339, 38 Sup. Ct. 543, 62 L. Ed. 1149.

purchased his shares the day before the declaration of the dividend at a price which would normally have included the value of the surplus adhering to his shares. It defines dividends as "one kind of gain to the individual stockholder" in the form of the "recurrent returns upon his stock." That it intended by its use of the term "gain" to restrict dividends to cases in which they involved the realization of a real increase in wealth for the stockholder seems doubtful since no point is made of the fact that the dividend involved in the case represented the realization of such an increase. That it would have held the dividend taxable in any event seems evident from its statement that

"We do not overlook the fact that every distribution diminishes by just so much the assets of the corporation, and in a theoretical sense reduces the intrinsic value of the stock."

The conclusion is not wholly certain since the Court immediately attempts to establish a probable gain in the value of the shares due to the payment of dividends, and further because the Court may have had in mind only that the act of receiving the dividend might involve no increase in wealth for the stockholder without committing itself on whether what was received must involve a realized increase in wealth to the stockholder if it is to be treated as a taxable dividend. However, the Court's final statement that "Congress laid hold of dividends paid in the ordinary course as de facto income of the stockholder, without regard to the ultimate effect upon the corporation resulting from their payment" seems rather to indicate a view that the taxability of dividends is independent of refined analysis of their effects upon the financial position of the individual stockholder. The practice is to include dividends in income regardless of whether the stockholder has paid a price for his stock that included the value of the surplus distributed by the dividend received, a position which is justified by the language in *United States v. Phellis*, heretofore cited, that such stockholder "necessarily took subject to the burden of the income tax proper to be assessed against him by reason of the dividend if and when made," that he "stepped in the shoes" of his vendor, and that "presumably the prospect of a dividend influenced the price paid, and was discounted by the prospect of an income tax to be paid thereon." The implications of *Stanton v. Baltic Mining Co.*,¹⁹ certainly negative the

¹⁹*Stanton v. Baltic Mining Co.*, (1916) 240 U. S. 103, 36 Sup. Ct. 278. 60 L. Ed. 546.

necessity of an increase in the taxpayer's wealth for the existence of income in the constitutional sense. The Supreme Court furthermore stated in *Taft v. Bowers*²⁰ that

"There is nothing in the constitution which lends support to the theory that gain actually resulting from increased value of capital can be treated as taxable income in the hands of the recipient only so far as the increase occurred while he owned the property"

The net result is that increase in the taxpayer's wealth is in some connections a requisite to the existence of, and a limit on the amount of taxable income, and in other situations a factor in neither. It is, however, certain that the absence of gain to the taxpayer in a given transaction will influence courts to find no income from it wherever the statutes permit such a construction.

Such doubts as surround the question whether there can be income to a taxpayer unless there has been a prior or concurrent increase in his wealth are not shared by the problem of whether there can be an increase in his wealth that is not income to him. The Stock Dividend case specifically stated that a "gain accruing to capital," a "growth or increment of value in the investment" is not income. The further fact required to make it income is its realization, but once that occurs it becomes income.²¹ That is a constitutional requirement before any acquisition can enter into the account between the government and the taxpayer regardless of whether it closes a transaction involving gain to the taxpayer or one that does not involve his enrichment. The result has been to make the problem of what constitutes realization an important one in connection with the income tax theory of income. The problem is to define those acts or events on whose occurrence the law permits and requires a taxpayer to treat as terminated any particular economic process that has entered into his economic activities. For example, the sale in 1929 of securities acquired in 1928 is the act that terminates the taxpayer's economic transaction of acquiring and holding those securities, and the effect upon the vendor of the economic forces bearing on that transaction during the entire period of his ownership of those securities is taken into account by the law only at the moment of sale. This does not mean that the law assumes that that act itself is the effective force responsible

²⁰(1929) 49 Sup. Ct. 199.

²¹*Merchants Loan & Tr. Co. v. Smietanka*, (1921) 255 U. S. 509, 41 Sup. Ct. 386, 65 L. Ed. 751.

for the existence of the income that the taxpayer is required to return. It means only that the law requires the occurrence of certain events before it treats those forces as having produced those effects on the taxpayer which it deems essential to the acquisition of income by him. The result is that income is in some instances assigned to an income period other than that in which the forces responsible for its existence were operative in so far as the tax year in which income is considered to have been realized may not include the whole of the period during which such forces were operative. A sale in 1929 at a price in excess of cost of acquisition in 1928 produces income for 1929 although there was no increase in value during 1929. The necessity for realization as an element in the constitutional theory of income, therefore, negatives any notion that income is limited to changes in a person's economic power occurring within the time period in which the law requires it to be reported. It is this legal conception of realization that has next to be considered.

The starting point for any discussion of this problem is to be found in the views stated in *Eisner v Macomber*. The principal reason for holding stock dividends not to be income was that their receipt involved no realization of anything. The Court's view of the essentials of realization are found in that part of its general discussion of income where income from property is described as "a gain, a profit, something of exchangeable value *proceeding from* the property, *severed from* the capital, however invested or employed, and coming in, being 'derived,' that is, *received or drawn by* the recipient (the taxpayer) for his *separate* use, benefit, and disposal, *that is* income derived from property. Nothing else answers the description." This definition of realization seems intended to fit all cases of receiving income from property. The requirement that the thing received must have exchangeable value has received very little consideration in the courts. Exchangeable value was identified with realizable market value in a case in which no income was held to have resulted to owners from their transfer of their property to a strictly family corporation;²² and the fact that certain securities received in the course of a reorganization had a readily realizable value was incidentally mentioned in *United States v Phellis*.²³ It is the other requirements that have furnished the difficulties.

²²*Bourn v. McLaughlin* (D.C. Cal. 1927) 19 F. (2d) 148.

²³(1921) 257 U. S. 156, 42 Sup. Ct. 63, 66 L. Ed. 180.

A highly analytical view would indicate that two further conditions must exist before income from property can be deemed to have been realized. (a) severance from the capital, and (b) receipt by the taxpayer for his separate use. The cases in which courts have employed the definition, however, have usually been almost wholly concerned with the question whether the transactions dealt with involved any receipt by the taxpayer of something for his own separate use. The conclusion, when that requirement is found to have been satisfied, is then sometimes formulated in the statement that the taxpayer has derived income from his capital investment.²⁴ The conception of separation from the capital is sometimes employed in the opinions to denote that separation from the corporate assets that is required by the decisions for the existence of dividend income to the stockholder and whose existence determines the conclusion that he has received a dividend, whether an ordinary or liquidating dividend.²⁵ It is in this sense only that the conception is used as an independent factor in judicial reasoning on the problem of realization of income from property. Its use as a test of the realization of income from property has a limited scope, although its convenience within those limits is undeniable and most of the cases in which the courts have dealt with this problem of realization have involved situations within those limits.²⁶ Even here, however, separation

²⁴See *Doerschuk v. United States*, (D.C. N.Y. 1921) 274 Fed. 739; *United States v. Phellis*, (1921) 257 U. S. 156, 42 Sup. Ct. 63, 66 L. Ed. 180.

²⁵*Eisner v. Macomber*, (1920) 252 U. S. 189, 40 Sup. Ct. 189, 64 L. Ed. 521, *United States v. Phellis*, (1921) 257 U. S. 156, 42 Sup. Ct. 63, 66 L. Ed. 180; *Michaels v. McLaughlin*, (D.C. Cal. 1927) 20 F (2d) 959.

²⁶The theory underlying this conception of severance from capital is that the realization of income by A requires the concurrent separation from the property of B of those assets whose acquisition constitutes A's income. There are, however, situations in which no one would deny that A had received income from property in which there is either no separation from the assets of another, or no such thing in the usual sense of that expression. An example of the former is the receipt by the owner of a farm of its annual produce which he himself entirely consumes. An example of the latter is furnished by the case of a producer who employs capital in his business and who realizes his income therefrom *pari passu* with the sale of the product; the purchaser's payment for the product does involve separating something from his assets; but in ordinary usage the producer is not for that reason described as realizing income by its separation from the purchaser's assets. The test in question is, however, a convenient one in those cases in which the recipient's property from which he derives income is invested in an enterprise not his own; dividends, bond interest, and rent from leased premises furnish examples.

from the capital and receipt by the recipient of something for his separate use are closely united in judicial reasoning on the problem of realization of income from property. This is true in *Eisner v. Macomber* and appears clearly in *Doerschuk v. United States*.²⁷ That case held that the payment to stockholders of the corporation's own bonds constituted the receipt by them of a dividend because they had "received an actual payment from the profits which the company wished to distribute as earnings to the stockholders" and which did not invest the holder of the bond "with merely a different form of holding stock." The emphasis here is on the effect of the transaction on the stockholder, the reference to its effect on the corporation being quite incidental. The problem of what constitutes the realization of income from property can, therefore, be best considered by treating the requirements of severance from capital and receipt of something for the recipient's separate use as intended to describe the same acts viewed from different angles. Since judicial discussion has emphasized the latter aspect, convenience of treatment will be served by adopting a like procedure.

The problem is to discover those facts that constitute the receipt by the taxpayer of something of exchangeable value for his separate use, benefit and disposal. It has been most discussed in cases in which the question was whether a stockholder had realized income from his investment in stock. The stockholder had admittedly received something in every one of the cases to be considered. The cases that raised the difficulties were those in which that thing was some form of corporate security of either the distributing corporation or a corporation that succeeded to its assets in the course of a reorganization. In them the issue was squarely raised as to whether the receipt of such security involved the receipt of something for the recipient's separate use. The security received was of course available for his separate use, but in none of the cases was so naive a conception even considered. That security was invariably considered as a mere symbol, and the question was whether the thing represented thereby had by the receipt of the symbol become available for the recipient's separate use. The decision that a stock dividend involves no realization of income for the stockholder is supported in part by the statement that "it does not alter the pre-existing propor-

²⁷(D.C. N.Y. 1921) 274 Fed. 739.

tionate interest of any stockholder." The payment of its own bonds to a corporation's stockholders is held to involve a realization of income by them although in substance each stockholder has after that transaction the same proportionate interest in the corporate assets as before.²⁸ There are differences between these two situations, but the question is whether those differences bear on the point in issue. The whole interest of a stockholder after a stock dividend is still an interest as a stockholder, and an interest in the whole pre-existing net corporate assets, while in the second situation the stockholder's interest after receipt of the bond is that of a stockholder in a part only of the pre-existing net corporate assets and of a creditor in the balance thereof which have thereby ceased to be a part of the net corporate assets. The substantial similarity of the two transactions, as far as their effects upon the maintenance of a pre-existing proportionality among stockholders is concerned, appears clearly when it is observed that an immediate liquidation after these transactions would produce exactly identical distributions to the stockholders who received the dividend stock or bonds, of the only pre-existing assets to which they had any claim. In *United States v. Phellis*, A Co. had organized B Co. under the laws of a different state from that of its own incorporation. It transferred all its assets to the latter in exchange for some cash, all of the preferred stock that B Co. issued, and all of B Co.'s common stock. The cash was used to pay off a part of A Co.'s bonds, the preferred stock to redeem the rest of its bonds and its preferred stock, the balance being retained to cover its own common stock par for par, the common stock was distributed to its stockholders. At the close of the reorganization the net assets of B Co. available for its common stockholders were less than the net assets of A Co. available for its stockholders prior to the reorganization by the extent of the preferred stock of B Co. retained by A Co. to cover its own common stock par for par, but an equal amount of B Co.'s assets were in substance reserved for those stockholders through their ownership of A Co.'s common stock. Since the distribution of the common stock of both companies at the completion of the reorganization was the same as in A Co. before that time, the proportionality of the stockholders' interests in A Co.'s assets was, if substance and not form be regarded, maintained for the same group's interest in the same assets after their transfer to B Co.

²⁸See *Doerschuk v. United States*, (D.C. N.Y. 1921) 274 Fed. 739.

The transaction, however, was held to have involved a realization of income for A Co.'s stockholders to the extent of the value of the B Co. shares received by them. A similar analysis of the facts in the other reorganization cases²⁹ would disclose the same situation, but in all but one of them³⁰ income was found to have been realized. Furthermore, it is as true of these transactions as of the distribution of a stock dividend that they do not "increase the intrinsic value of his (the stockholder's) holding or of the aggregate holdings of the other stockholders as they stood before."³¹ If, then, these cases are to be deemed consistent with *Eisner v. Macomber*, the essence of realization will have to be found in some feature other than the maintenance after the transaction of the same proportionate distribution of interests among the same group of stockholders that existed before it, and other than those mentioned in the quotation last set forth. The reasoning in these cases, particularly fully set forth in the *Phellis Case*, throws some light on this matter.

The strongest argument urged by the taxpayer to support the theory that the distribution in the *Phellis Case* involved no realization of income was predicated on the theory that the old and the reorganized corporations were substantially identical, and that, therefore, there had been a mere distribution of certificates indicating an increase in the value of the stockholder's capital holdings. The Court's answer consists of an argument that is principally concerned with proving that the two corporations were not substantially identical. The facts relied on were that the plan of reorganization contemplated a new corporation, that the reorganized corporation was organized under the laws of a different state which "imported a different measure of responsibility to the public, and presumably different rights between stockholders and company and between stockholders inter sese than before," and certain other facts of dubious relevancy. Hence it was held the new company must be treated as "a substantial corporate body with its own separate identity, and its stockholders as having

²⁹*United States v. Phellis*, (1921) 257 U. S. 156, 42 Sup. Ct. 63, 66 L. Ed. 180; *Rockefeller v. United States*, (1921) 257 U. S. 176, 42 Sup. Ct. 68, 66 L. Ed. 186; *Cullinan v. Walker*, (1923) 262 U. S. 134, 43 Sup. Ct. 495, 67 L. Ed. 906; *Marr v. United States*, (1925) 268 U. S. 536, 45 Sup. Ct. 575, 69 L. Ed. 1079.

³⁰*Weiss v. Stearn*, (1924) 265 U. S. 242, 44 Sup. Ct. 490, 69 L. Ed. 1001.

³¹*Eisner v. Macomber*, (1920) 252 U. S. 189, 40 Sup. Ct. 189, 64 L. Ed. 521.

property rights and interests materially different from those incident to ownership of stock in the old company." The result of the distribution of the reorganized company's common stock, therefore, transferred to the stockholders of the original company "new individual property rights in realization of their former contingent right to participate eventually in the accumulated surplus;" this is a justified conclusion if the two corporations are treated as separate entities as the Court did treat them. Substantially similar reasoning underlies the other reorganization cases whose decisions accord with that in the *Phellis Case*, and the theory of *Weiss v. Stearn* is not in conflict therewith however much its results may be irreconcilable with the other decisions. In *Marr v. United States*, in which the question of Congress' power to tax such transaction was squarely discussed, the Court expressly approved the government's contention that a stockholder realized income not only when he acquired "an interest in a different business enterprise or property" but also when he acquired "an essentially different interest in the same business enterprise or property." The result of these cases, therefore, is that a stockholder realizes income from his investment in his stock whenever his prior interest in the corporate assets, or some part thereof, is after a transaction represented by an essentially different interest therein than his interest therein before the transaction. The stock dividend decision rests in the final analysis upon the theory that the stockholder's interest in the corporate assets was essentially the same before and after that transaction. The principle is equally applicable to ordinary dividends and liquidating dividends of the usual type, in which the resulting transformation of the stockholder's interest in a part or all of the corporate assets is clear;³² it is only where these have been incidents to reorganizations that controversies have arisen. It is patent, therefore, that the crucial question is what differences justify the conclusion that interests are essentially different. The difference is clear enough when dividends are paid in cash, or when paid by distributing part of the corporate assets in kind.³³ The answer

³²See *Langstaff v. Lucas*, (D.C. Ky. 1925) 9 F (2d) 691, aff'd (C.C.A. 6th Cir. 1926) 13 F (2d) 1022, certiorari denied, (1926) 273 U. S. 721, 47 Sup. Ct. 111, 71 L. Ed. 858, for discussion of the question as applied to liquidating dividends. The case of *Cullinan v. Walker*, (1923) 262 U. S. 134, 43 Sup. Ct. 495, 67 L. Ed. 906, also involved a liquidating dividend.

³³*Peabody v. Eisner*, (1918) 247 U. S. 347, 38 Sup. Ct. 546, 62 L. Ed. 1152, furnishes an instance of an ordinary dividend of this

is not quite as easy where the stockholder receives the distributing corporation's own bonds, although the decision in *Doerschuk v. United States*³⁴ is justified since the stockholder by such transaction became a creditor with respect to assets in which his former interest was that of a stockholder's interest in surplus, and the difference in legal nature between these involves a real difference in economic interest as well. The differences relied on in the reorganization cases were of rather a technical legal nature. That they may have involved parallel changes in the economic nature of the stockholder's interest is probable if that term be given a rather broad scope, that such incidental economic changes were important is doubtful except in *Cullinan v. Walker*³⁵ and *Weiss v. Stearn*.³⁶

That the Court did not expressly measure the significance of those changes by economic considerations is clear, in fact it found no realization of income in *Weiss v. Stearn* in which, taking a stockholder's entire interest in the old company as a unit, the economic changes were the most pronounced. Furthermore, the adoption of the definition of realization of income by a stockholder that emerges from the reorganization cases reconciles their decision with that of *Eisner v. Macomber* only by defining the test of the existence of essential differences in interests in terms that exclude at least some significant legal and economic changes in interest. A share of stock represents an interest in the corporate net assets. If the corporation has a surplus, the share represents one kind of interest in that fraction of the net assets that offsets the capital stock, and another kind of interest in that part thereof that offsets the surplus, the difference in the legal nature of his interests in these respective parts is generally recognized, and the importance of the parallel economic differences is at least as great as in the cases in which realization was found to exist. A stock dividend transforms the one interest into the other, and therefore does involve the stockholder's acquisition of a different interest in the same enterprise or property, the decision of *Eisner v. Macomber* shows, however, that the difference is not an "essential" difference. It is not intended to convey

character. *Langstaff v. Lucas*, (D.C. Ky. 1925) 9 F. (2d) 691, aff'd (C.C.A. 6th Cir. 1926) 13 F. (2d) 1022, of a liquidating dividend of that type.

³⁴(D.C. N.Y. 1921) 274 Fed. 739 (1921).

³⁵(1923) 262 U. S. 134, 43 Sup. Ct. 495, 67 L. Ed. 906.

³⁶(1924) 265 U. S. 242, 44 Sup. Ct. 490, 68 L. Ed. 1001.

the idea that the transformation in interest last mentioned should have received recognition by treating stock dividends as income, but only to indicate that the decisive factor should be the nature of the transformation. The Court did point out in *Eisner v. Macomber* that the transformation there effected resulted in the permanent capitalization of what had formerly been free surplus, a consideration that may well justify that decision, but it did not adequately dispose of the argument for a similar treatment of the transformations in interest involved in the reorganization cases. These cases, therefore, show that a stockholder realizes income, that is, receives something for his separate use, whenever the transaction results in his acquisition of an essentially different interest in what were the corporate assets before the transaction than the interest he had therein before it, and that no satisfactory generalization is possible as to what constitute essential differences.³⁷

The objection urged by the taxpayers in the cases just considered was that a transaction had realized no income for them because they had nothing different from what they had before, and, therefore, that there was nothing that could have been received by them. This objection would not be available to the person who has performed labor for hire or sold a capital asset, since they could not have after those transactions the same things they had before them. The normal consequences of those transactions are the acquisition by the worker or vendor of legal claims of some character. Similarly when a corporation declares a dividend payable at some future date, the stockholder becomes a creditor immediately upon declaration of the dividend, and, therefore, the transformation of the stockholder's interest in the corporate assets occurs at that moment. The question suggested by these situations is whether the mere acquisition of those claims, or the fact that the stockholder becomes such creditor, constitute the receipt of income. The emphasis in the dividend and reorganization cases was on the acquisition of interests in property but property in this connection was not defined since the cases did not call for it. A claim against another, or against property is in one sense itself property. A taxpayer reporting on an accruals basis treats income as realized in most situations at the moment he acquires a receivable, on the other hand, one who reports on

³⁷See E. Seligman, *Implications and Effects of the Stock Dividend Decision*, 21 Col. L. Rev. 313.

the cash receipts and disbursements basis considers income realized only when he comes into possession of the thing to which the claim entitles him, or some other thing taken in substitution therefor. The question has usually arisen in cases in which the issue concerned the tax period in which income was to be reported, and has been considered rather in connection with the problem of statutory construction than that of constitutional power. The most decisive factor in answering it is the manner in which the taxpayer reports his income. The most usual ways of reporting income are on the basis of accruals or of cash receipts and disbursements, others recognized either by Treasury practice or statute are the job basis³⁸ and installment method.³⁹ The detailed discussion of these methods lies beyond the scope of this article, it is sufficient to state that the first fact to ascertain in any case which considers the present aspect of the problem of the realization of income is the method on which the taxpayer reports.

A person may come into the possession of property in fruition of a claim thereto even though the tangible fruits of such claim are never in fact under his separate control. A lessor railroad is deemed to receive rent although the lessee pays the sums due under the lease directly to the lessor's security holders, the theory being that the payment to the security holders discharges a claim due the lessor from the lessee and is thus constructively received by such lessor.⁴⁰ The assignment of income does not prevent the assigned income from being deemed received by the assignor unless the transaction amounts to the creation of a direct claim in favor of the assignee against the obligor, in which case it becomes income to the assignee.⁴¹ The point of present interest in these assignment cases is not whether and under what circumstances such transaction produces income to the assignor,⁴² but that in those cases in which it is held that it does he is deemed to receive it although he never has any but a constructive possession thereof. The issue in the above cases was not the time

³⁸See *Thomas Cronin Co. v. Lewellyn*, (D.C. Pa. 1925) 9 F (2d) 974.

³⁹See, e.g., Revenue Act of 1928, sec. 44.

⁴⁰*Rensselaer & S. R. Co. v. Irwin*, (C.C.A. 2d Cir. 1918) 249 Fed. 726.

⁴¹See *Hamilton v. Comm. of Int. Rev.*, (C.C.A. 1st Cir. 1928) 24 F (2d) 668, *Young v. Gnichtel*, (D.C. N.J. 1928) 286 F (2d) 789, *Bing v. Bowers*, (D.C. N.Y. 1927) 22 F (2d) 450.

⁴²See R. F. Magill, *The Taxation of Unrealized Income*, 39 Harv. L. Rev. 82.

income was returnable but the existence of any income to the taxpayer, and hence no point was made of the taxpayer's method of reporting income. The cases next to be reviewed involved the time problem. In the normal case the claim that matures by the claimant coming into possession of its fruits arises either before or concurrently with those facts that constitute its satisfaction. In those cases the income is deemed received when the taxpayer acquires possession of the thing to which the claim entitled him, if he reports on the cash receipts and disbursements basis.⁴³ It was held in one case that mere acquisition of the legal title was insufficient, and that the subsequent time when possession was acquired fixed the year in which it was taxable.⁴⁴ The circumstances of that case were, however, peculiar, since the assets whose legal title was acquired were retained by others in connection with winding up a corporation's business. Attempts have sometimes been made by a taxpayer reporting on the last mentioned basis to assign income to a period prior to that of the actual receipt of the thing to which his claim entitled him. The theories on which such attempts have been based have varied with the facts of the particular cases. A receiver who was granted a large additional compensation at the close of the receivership sought to sustain his claim that this sum should be spread over the years of the receivership by reliance on a court order allocating it over such period, but the attempt failed.⁴⁵ Equitable principles have been appealed to in vain.⁴⁶ The taxpayer who reports on the cash receipts and disbursements basis cannot treat a claim to future payment, whatever its basis, as the equivalent of the thing itself. It has even been suggested that *Eisner v. Macomber* prevented including dividends declared in one year but payable in another as income for the former,⁴⁷ despite the fact that the date of declaration has been held to fix the time when it becomes a part of the stockholder's accumulated capital.⁴⁸ A taxpayer cannot,

⁴³Langstaff v. Lucas, (D.C. Ky. 1925) 9 F (2d) 691.

⁴⁴Wells Fargo Bk. & Un. Tr. Co. v. Blair, (D.C. App. 1928) 26 F (2d) 532.

⁴⁵Jackson v. Smietanka, (D.C. Ill. 1920) 267 Fed. 932, aff'd (C.C.A. 7th Cir. 1921) 272 Fed. 970.

⁴⁶Kales v. Woodworth, (D.C. Mich 1927) 20 F (2d) 395; Stieff v. Tait, (D.C. Md. 1928) 26 F (2d) 489; compare with latter Davidson & Case Lbr. Co. v. Motter, (D.C. Kan. 1926) 14 F (2d) 137, in which, however, the taxpayer reported on an accruals basis.

⁴⁷See Kales v. Woodworth, (D.C. Mich. 1927) 20 F (2d) 395; this does not apply where taxpayer reports on an accruals basis.

⁴⁸United States v. Guinzburg, (C.C.A. 2d Cir. 1921) 278 Fed. 363.

however, postpone the time when he must return income by voluntarily failing to receive what he is presently entitled to receive and which is presently available to him. Neither can the government forcibly postpone the actual receipt of income, and then treat it as taxable in a later year when it permits the taxpayer actually to receive it.⁴⁹ The time of actual acquisition of title or possession, when that was prior to the effective date of the sixteenth amendment, has also been held to prevent income being treated as received at a later period, although economic analysis would have required the latter result. Such was the holding that the value of a building constructed on leased premises, and which was to belong to the lessor on the expiration of the term, was received by the lessor at the time of its construction, not at the expiration of the term, despite the fact that the court recognized that it represented a prepayment of rent distributed over the whole term.⁵⁰ The decision is justified, but not by the reasoning employed. Another court held that the annual amount of amortization of the premium on bonds issued in 1904 was not income for various reasons, including that that it was received before Congress had power to tax such income without apportionment.⁵¹ The decision may be justified for the other reasons assigned despite the fact that the treatment contended for by the government seems more reasonable under any statute that permits the deduction as interest paid of the entire amounts paid to the bondholders, particularly as applied to a taxpayer on the accruals basis, but the above stated reason of the court embodies too naive and literal a conception of "received." The same remark applies to the case just before stated.

There are, however, cases in which actual receipt precedes the transaction that produces the income. When a person comes into possession of another's property, or acquires the legal title thereto and possession thereof, by a transaction that is neither donative, testamentary under the laws of intestate succession, or in satisfaction of a pre-existing or concurrently arising claim, there arises a claim in favor of some one against the recipient. It is clear that such transaction would involve no income for the recipient at that time. If it is to affect his income in any manner another transaction will be required. This is what occurs when

⁴⁹*Forstmann v. Ferguson*, (D.C. N.J. 1926) 17 F (2d) 659.

⁵⁰*Miller v. Gearin*, (C.C.A. 9th Cir. 1919) 258 Fed. 225.

⁵¹*Comm'r of Int. Rev. v. Old Colony R. R. Co.*, (C.C.A. 1st Cir. 1928) 26 F (2d) 408.

the claim against the recipient is cancelled by the person then entitled thereto, and the logical view would be that the recipient had received income in the tax period in which that later act occurred. It is then that his interest in the property received is transformed if it be still in existence as part of the total property in his possession or in his ownership and possession, or, if it is no longer thus existent, that an essential change in interest occurs in respect of his prior interest in the totality of his property rights. If now this later transaction is one which, had the transfer of the property occurred concurrently with it, would have produced income to such recipient, then its subsequent occurrence in relation to such prior transaction should mark the time when the larger transaction composed of those two results in the receipt of income to such recipient. This result has been reached in at least one case. In *Holbrook v. Moore*⁵² the president of a corporation had overdrawn his salary prior to March 1, 1913, thereafter in 1913 the directors voted him additional compensation which was paid by a credit against his overdraft, this cancellation of his liability for the assets in fact received from the corporation before the effective date of the 1913 Act was held to constitute a receipt of income by him at the time of such cancellation. The results in *Southern Pacific Co. v. Lowe*⁵³ and *Gulf Oil Co. v. Lewellyn*⁵⁴ are contrary to the above case, but the reasons advanced in support of those decisions are such as prevent them from being considered as instances of the type situation now being discussed. If accrual to the subsidiary is treated as equivalent to accrual by the parent corporation because of their substantial identity, then the parent's possession of the tangible benefits arising from the maturing of the accrued items would raise merely a technical legal claim of the subsidiary against the parent which these cases proceeded to ignore with the result that the subsequent distribution of a dividend in said amounts by the subsidiary to the parent would not involve the cancellation of a real claim, but only of a formal legal one. The same emphasis on the controlling effect of substance explains a later case in which withdrawals by two persons who comprised all the stockholders in a corporation of sums proportionate to their stock holdings were held to be income for that year rather than for the following year when matters were regularized through the declaration

⁵²(D.C. Mo. 1921) 293 Fed. 264.

⁵³(1918) 247 U. S. 330, 38 Sup. Ct. 540, 62 L. Ed. 1142.

⁵⁴(1918) 248 U. S. 71, 39 Sup. Ct. 35, 63 L. Ed. 133.

of a dividend for the amounts withdrawn.⁵⁵ It thus appears that the time when a claim, arising out of the actual receipt in possession of another's property, is cancelled determines the time when income in the amount of such receipt is received only where the claim is more than a formal legal one substantially within the recipient's control. If, however, the cancelled claim arising out of the kind of transaction now being considered is not merely a legal one but a real one as well, its cancellation constitutes the receipt of income and determines the time of such receipt. It is assumed throughout the foregoing discussion that the cancellation or discharge of the liability was neither donative, testamentary, under the laws of intestate succession, in satisfaction of a pre-existing or currently arising other claim, or in the nature of a contribution to capital. It should also be noted that the principle therein considered might have to be modified in application if the taxpayer reported on an accruals basis. A firm of tax consultants reporting on that basis which had in 1928 received an overpayment for a job wholly performed in that year would undoubtedly be sustained in treating the overpayment as 1928 income even though the client had agreed to waive his claim to have the excess returned in 1929.

The discussion in the preceding paragraph dealt with the effect of the cancellation of claims upon the receipt of income and the time of its receipt. An analogous problem arises when A in accordance with an agreement with B discharges an obligation of B to C. There is no receipt of income by B from A until a liability of B to C comes into existence. It has been held that a lessor railroad received no income for 1918 from the lessee's payment of the former's 1918 income tax since lessor's liability for such tax could not have arisen prior to 1919 in which the tax law applicable to 1918 was passed.⁵⁶ There is no doubt, however that the lessor would have been held to have received income if any of its liabilities arising in 1918 had been discharged by the lessee in 1918, that it would, if on an accruals basis, have been held to have received income in 1918 even had the lessee discharged any of the lessor's liabilities arising in 1918 during 1919 under an agreement existent during 1918, and that, in the last situation, it would have been held to have received income in

⁵⁵*Chatanooga Sav. Bk. v. Brewer*, (C.C.A. 6th Cir. 1926) 17 F (2d) 79.

⁵⁶*United States v. Norwich & W. R. Co.*, (D.C. Mass. 1926) 16 F (2d) 944.

1919 had it been on a cash receipts and disbursements basis. Another analogous situation is presented by the case of the payment of wages in advance, the workman, if on an accruals basis can undoubtedly deem that received *pari passu* with those acts of his that discharge his liability to his employer, that is, those acts that give rise to a claim against such employer which the latter has paid off in advance, nor is there any doubt but that the workman would be required to return that payment as of the time of its actual receipt if he reported on a cash receipts and disbursements basis.

The situation with respect to the legal theory of realization of income may conveniently be summarized before proceeding to other problems. Realization, rather than mere realizability, is a constitutional condition to the existence of income for a taxpayer. The essential element in realization is the acquisition of an interest in property in which the taxpayer had no interest before the transaction from which the income arises, or of an essentially different interest in the same property after than before such transaction. The former sometimes reveals itself by the fact that the taxpayer's wealth is increased by a new asset, sometimes by a mere substitution of assets, while the latter shows itself by the fact that that wealth has been affected by a substitution of one asset for another. This does not mean that proof of these facts alone establishes that the taxpayer has realized income, the character of the transaction that resulted in such changes in the taxpayer's position has also to be considered, and if that is, for example, a pure capital transaction the existence of the above facts will not convert it into an income transaction. A corporation does not acquire income from the payment to it of the subscription prices of its stock. The requirement above stated does, however, mean that there can be no income for a taxpayer from a transaction unless it involves the changes in his position indicated above. Furthermore the complete description of the concept of realization involves the determination of what constitutes acquisition or receipt. This is frequently equivalent to what shall be considered as assets in applying the theory that income is realized when a taxpayer acquires a new or different asset in a non-capital transaction. The acquisition of a mere receivable is sufficient if the taxpayer reports on an accruals basis, but not only not sufficient but not even permitted to be so treated if he reports on the cash receipts and disbursements basis. A taxpayer on the

latter basis is deemed to receive income when he comes into actual possession of the new or other asset, and will not be allowed to treat it as income received at any other instant, but cancellation of a claim against him, the discharge by another of an obligation of the taxpayer, and the acquisition of actual possession by another to whom he has directed it be paid, are the legal equivalents of coming into possession by a taxpayer reporting on said basis, and have an importance in some connections even for a taxpayer on the other basis. The decisions establish the first factor in realization on a constitutional basis, theories as to the second are based almost wholly on cases interpreting the various income tax statutes, and thus afford only indirect indications of what the constitution requires.

The case of *Holbrook v Moore*,⁵⁷ in which the president of a corporation was held to have received income when the directors voted him additional compensation for prior years which was credited against his overdrafts during such prior years, has already been discussed. The net effect of the corporation's acts was the reduction of the president's liabilities in the year in which the directors voted said additional compensation. The case raises the question whether the mere reduction of a taxpayer's liabilities constitutes income for him. The answer of the cases is clearly in the negative. In *Michaels v McLaughlin*⁵⁸ the extinction of a stockholder's contingent liability to pay the balance due the corporation on the stock issued him by a direct transfer of that amount from surplus to capital stock was held to produce no income to the stockholder. The court treated the transaction as in substance a stock dividend, and its reasons were phrased largely in terms of the reasoning in *Eisner v Macomber* although the contingent character of the liability received due emphasis. In an earlier case under the 1909 excise tax act a corporation which was the sole stockholder of another cancelled its claim against the latter which had arisen out of advances to it for financing its capital requirements. It was held that the latter derived no income since "the cancellation of the debt was a means of contribution to its capital account," and income should not "include such wealth as is honestly appropriated to what would customarily be regarded as the capital of the corporation taxed."⁵⁹ The facts of *Bowers*

⁵⁷(D.C. Mo. 1921) 293 Fed. 264.

⁵⁸(D.C. Cal. 1927) 20 F (2d) 959.

⁵⁹*United States v. Ore.-Wash. R. & Nav. Co.*, (C.C.A. 2d Cir. 1918) 251 Fed. 211.

*v. Kerbaugh-Empire Co.*⁶⁰ will be stated in full. A Co. borrowed money during the period of 1911-1913 on notes repayable in German marks. The sums so borrowed were loaned by it to B Co., a subsidiary all of whose stock was owned by it, which used them to finance the performance of certain construction contracts. B Co. had lost the sums thus loaned to it during the years 1913, 1914, 1916, 1917 and 1918, and had deducted them in its tax returns for those years. It does not appear that this meant anything more than that B Co. during those years incurred losses, but, even if it meant that the specific assets acquired by B Co. from A Co. when the latter made the loans to the former were lost during those years, the result should be unaffected since it seems absurd to transform the problem of determining the existence of income into an investigation of the life history of specific assets when it is changes in their value aspects alone that are important. It is only the Court's emphasis on the fact that the borrowed money was lost that renders the last remarks necessary. A Co. repaid the loan in 1921 in marks that were depreciated in terms of the dollar. The result was that A Co. had acquired assets having a value of X dollars when borrowing in exchange for its promise to pay marks, and that it redeemed that promise in 1921 by surrendering assets of the value of X-Y dollars. The advantageous payment of its obligation marked the conclusion of a process whose effect upon it was an increase in its net assets, that is, in its wealth, which can be assigned to 1921, even though due to forces spread over other years as well, for the same reason that gains on the sale of capital assets are treated as income in the year of sale even though the increase in value accrued over a period of years. The sole question in the case should have been the effect on A Co. of the transaction that began with its borrowing and terminated with the repayment of the loan. The Court, however, held that A Co. received no income from this transaction in 1921. Its reason was that the whole transaction resulted in a loss, presumably to A Co., because the borrowed money was lost, and that this loss exceeded the saving incident to the repayment in depreciated marks. The reasoning is quite inadequate and inaccurate. There was no proof that A Co. had as yet lost anything unless loss by its subsidiary, B Co., be considered as its loss, but, if that view be adopted, reason would require that the deduction by B Co. of those losses in its tax

⁶⁰(1926) 271 U. S. 170, 46 Sup. Ct. 449, 70 L. Ed. 886.

returns be treated as deductions thereof by A Co., in which case the effect of the present decision would be to permit the same item to be twice deducted. Furthermore, the statement that the whole transaction resulted in a loss to A Co. is inaccurate, for the conclusion most favorable to the Court's view that the facts warrant is a loss to A Co. from wholly distinct transactions. The transaction in question was one between A Co. and the German lenders, the transactions producing the loss were between it and B Co., or, if losses by B Co. are to be deemed those of A Co., transactions between A Co. and the other parties to the construction contracts. The logic of the Court's view leads to the conclusion that, if C makes a profit from the sale of a share of stock which he invests in a bond that becomes worthless, he cannot be held to have received income from the former transaction because the gain was lost in another transaction. There is no indication as to what the Court would have held had there not been those losses that play the decisive role in its reasoning, or had they been less than the saving to A Co. from the payment of its debt in depreciated marks. It has frequently emphasized that income in connection with income tax matters means the same thing as in the 1909 Excise Tax Act. It has been held under that Act that the write-off of outlawed debts produces income to the debtor for the year of the write-off.⁶¹ That would require treating partial write-offs, which is in substance the effect of the transaction in the German mark case, as income except where the purely adventitious factor present in that case, or some other such factor, prevented it. To revert to that case. If its decision is to be either legally or economically justified, it will have to be on the theory that the transaction taken as a unit produced a capital receipt to A Co. The parties to it certainly did not intend it as such, nothing about it marks it as such, and the Court clearly did not so treat it. The decision seems unsound, but whatever doubts may exist on that score do not extend to the reasoning by which the Court justified its conclusion.

The proper evaluation of the legal justification of the decisions discussed in the preceding paragraph will at least be aided by taking certain economic considerations into account. The necessary effect of a transaction that decreases a person's liabilities without a concurrent equivalent reduction of assets is to increase that person's net assets, i.e., his wealth. That is true whether the decrease

⁶¹Great North. Ry. Co. v. Lynch, (D.C. Minn. 1921) 292 Fed. 903.

results from the total or partial cancellation of a claim by the creditor, from the discharge of the claim by some one other than the creditor,⁶² or from the payment of a debt with assets of lesser money value than those promised when the debt was incurred. The interest of the debtor in his assets prior to such transaction included the element of their liability to be applied to satisfy that debt, transactions of the above character produce changes in his interest in his assets so that it is perfectly reasonable to treat it as the acquisition of a different interest in the same assets. The legal theory requires the new interest to be essentially different; the resulting difference is essentially different from the point of view of economic analysis since what has happened is a redistribution of economic claims to those assets involving an increase in the debtor's claims thereto. It is difficult to see why this is not an adequate basis on which to predicate the legal conclusion, "essential difference," which the legal theory requires. In the light of this analysis the decisions in the cases discussed in the preceding paragraph, with the exception of that in *Holbrook v. Moore*, seem clearly wrong, unless something in the nature of the acts that produced the increase in the debtor's net assets justifies them. Cancellation of a debt, or discharging another's debt to a third person, may constitute gifts or bequests and therefore not taxable under the tax acts, such was not the situation in the cases in question. Such acts may constitute ways of making capital contributions, in this case by the party cancelling or discharging the claim to the capital of the debtor. Normally one person does not make a contribution to the capital of another unless the latter assumes some kind of liability to the former in respect thereto. When a stockholder contributes to the corporate capital this liability, though legally existent, is formal rather than substantial from an economic point of view. The cancellation by the sole stockholder of a debt incurred by the corporation to the stockholder amounts in substance to such stockholder locking up the amount of such debt in the enterprise which is in an economic sense his own, and is reasonably construed as a capital transaction, hence the decision in *United States v. Oregon-Washington River & Navigation Co.*⁶³ is justified even though some of its

⁶²Where the person discharging the claim does so because obligated by agreement with the debtor, there occurs a concurrent equivalent reduction of the debtor's assets; cases are, however, conceivable in which no such diminution occurs.

⁶³(C.C.A. 2d Cir. 1918) 251 Fed. 211.

reasoning is faulty. The extinction of a stockholder's liability for the unpaid subscription price of his stock by a transfer from surplus to capital stock is essentially the payment of a dividend from surplus and its use to pay off the debt. The former is as clearly an income transaction as the latter is a capital one. The decision in *Michaels v. McLaughlin*,⁹⁴ thus appears to make form rather than substance the controlling factor. The increase in the debtor's net assets in the German mark case was certainly not due to a gift or to a capital transaction, the decision in that case is clearly wrong. The result of the various decisions involving the effects upon income of transactions that decrease a person's liabilities without an equivalent diminution in his assets is that they give rise to income unless the result of a gift, bequest, or capital transaction, but in no case do they involve income if the assets acquired in exchange for the liability in question have been diminished by losses equal to or in excess of the increase in net assets resulting from the cancellation, discharge, or advantageous payment of the liability. The qualification is clearly unsound, although it may afford a method for taking care at least in part of such cases as compositions with creditors, discharges in bankruptcy, and the voluntary scaling down of claims incident to receiverships and reorganizations. These might be equally well taken care of if treated as gifts of capital, which is what they are as far as their essential economic character is concerned. It should at least be pointed out that the implications of said qualifications produce some strange results in so far as it takes no account of the prior treatment of such losses for income tax purposes. If, for example, a manufacturer should buy raw materials on credit for X dollars, he will set them up on his books at that figure. They will, when completely used up, have entered the cost of goods sold on that basis. If the debt for them is later discharged for X-Y dollars, his cost of goods sold will have been overstated, and to that extent will his profits have been understated with a consequent underpayment of his taxes. The like result would follow if, as seems likely, losses in respect of the assets thus acquired will have been computed on the basis of a cost of X dollars. The theory of the government in the German mark case would have prevented this result by increasing income by an offsetting gain either in the same or some later tax period. It is interesting to speculate on what the Court would do if the

⁹⁴(D.C. Cal. 1927) 20 F (2d) 959.

government should require the taxpayer to file amended returns to correct the overstatement of cost of goods sold or of losses in the situations just presented. The same question might be asked as to the case of an insolvent who effects a composition with creditors, and a bankrupt whose estate pays less than the full value of the claims against him.

Legal theory and economics agree on distinguishing income from capital. Such statements as that the former is a flow while the latter is an accumulated or accumulating fund are correct enough but afford rather a starting point for further analysis than an immediate basis for the solution of concrete problems. The same applies to the figurative language of the Court in *Eisner v. Macomber* that capital is the tree, income its fruit. The constitution prohibits the taxation of capital as such without apportionment among the states on the population basis. Hence the necessity of drawing the line between capital and income. The starting point is the fact that the concept of capital refers to the state of a person's wealth at a given instant of time whereas income denotes changes therein occurring within a given period of time. It follows that the receipt of something during a given period would not be income for that period if it gave the recipient nothing that was not already his at the beginning of said period. It thus becomes necessary to fix upon some instant of time as the point from which to measure the effects of subsequent transactions upon a person's wealth in order to determine whether or not the transactions involve income for him. The most important instant of time in connection with the income tax is the date on which the sixteenth amendment became a part of the Constitution, which was February 3, 1913. The statutes have, however, for purposes of convenience adopted March 1, 1913, as the significant date. The receipt by a stockholder of a liquidating dividend in 1914 in an amount not in excess of the value of his interest at March 1, 1913, was held to produce no income to him.⁶⁵ Various reasons were assigned. It was stated that the transaction involved a mere change in the form of his property which produced no income because its value was the same before as after the change. This reasoning is clearly inadequate since it would prevent treating income as ever derived from a liquidating dividend, the gains on such a conversion of the stockholder's capital

⁶⁵*Lynch v. Turrish*, (1918) 247 U. S. 221, 38 Sup. Ct. 537 62 L. Ed. 1087

interest have, however, been held taxable.⁶⁶ It is also inadequate insofar as it requires gain from the particular transaction since that is inconsistent with *Lynch v. Hornby*,⁶⁷ and would prevent the taxation of realized capital gains. The substance of its other reason is that, since the gain realized by the conversion accrued prior to the effective date of the tax law, it had become capital at that date in an amount equal to that received on liquidation, and that, therefore, it involved a mere receipt of capital without an element of gain. It is patent that the surplus adhering to a share at such date should be equally capital if later distributed as an ordinary dividend. It is not the character of the act by which the stockholder later realizes his interest, but its status as an element in his wealth at a given date, that should determine whether it is capital or something else at such date. Nevertheless it was held in *Lynch v. Hornby*, already cited, that a distribution from such pre-March 1, 1913, surplus by way of an ordinary dividend constituted income to the stockholder. Nor can these two cases be reconciled by invoking the definition of realization of income later developed in *Eisner v. Macomber*, that definition states merely that certain conditions must exist if a transaction is to produce income, not that every transaction in which they exist has that result. Furthermore they were equally existent in *Lynch v. Turkish* as in *Lynch v. Hornby*.

There are, therefore, some situations in which the mere conversion without gain after March 1, 1913, of what was part of the recipient's capital fund at said date produces income to him, and others in which it does not. The majority of the situations are treated under the second category. The capital fund may be a mere legal claim as well as an interest of some sort in particular physical assets or in an enterprise, in fact refined legal analysis might well reduce the latter to types of legal claims. It has been held that dividends declared prior to March 1, 1913, though payable thereafter, and interest due on said date for the period ending on February 28, 1913, were capital at March 1, 1913, so as not to be includible in income for the period when actually paid.⁶⁸ If the claim is in the form of a binding promise to make a series

⁶⁶Langstaff v. Lucas, (D.C. Ky. 1925) 9 F. (2d) 691.

⁶⁷(1918) 247 U. S. 339, 38 Sup. Ct. 543, 62 L. Ed. 1149.

⁶⁸As to former, see United States v. Guinzburg, 278 Fed. 363 (1921) in which the government sought to tax the whole amount received rather than the excess thereof over its March 1, 1913, value. As to latter, see Plant v. Walsh, (D.C. Conn. 1922) 280 Fed. 722.

of fixed payments over a period of years, the courts have correctly computed the capital value which the promisee is entitled to receive without tax at the discounted March 1, 1913, value of such payments, and their reasoning on that matter has followed approved economic analysis.⁶⁹ If, however, the future payments depend on contingencies that may result in their never being receivable, their capitalization at their March 1, 1913, value is not permitted. Commissions due insurance agents on renewal premiums furnish a case in point.⁷⁰ If future payment of some amount is reasonably certain at March 1, 1913, but the exact amount is contingent, capitalization has been allowed on the basis that the future payment equalled the amount which on March 1, 1913, was reasonably certain to be paid.⁷¹ It would seem that the contingency present in the renewal commissions cases above referred to might well be resolved by applying some factor of probability statistically determined so as to bring these cases within the principle of the case last cited, since the contingency in substance affected the amount of future commissions. In a few cases the courts have treated the whole amount received after March 1, 1913, on a claim owned at that date as non-taxable, but whether they would have so held had this aspect of the problem been called to their attention cannot be determined.⁷² The general rule is, therefore, that the wealth owned by a taxpayer at March 1, 1913, is deemed capital for income tax purposes and that its conversion after said date is tax free to the extent of its value at said date. Transactions within the principles of *Lynch v. Hornby* constitute a clear exception. It is the only one of the cases that discussed the constitutional issue, but it would seem equally clear from the basis of *Lynch v. Turrish* that Congress could not have treated the stockholder's receipts therein as income. Attention should be directed to one extension of this doctrine. The decisions in *Goodrich v. Edwards*⁷³ and *Walsh v. Brewster*⁷⁴ protect not only the taxpayer's capital at March 1, 1913, but that value plus decreases

⁶⁹*Platt v. Bowers*, (D.C. N.Y. 1926) 13 F (2d) 951, *Ruth Iron Co. v. Comm'r of Int. Rev.*, (C.C.A. 8th Cir. 1928) 26 F (2d) 30.

⁷⁰*Edwards v. Keith*, (C.C.A. 2d Cir. 1916) 231 Fed. 110; *Woods v. Lewellyn*, (C.C.A. 3d Cir. 1918) 252 Fed. 106. See also J. M. Maguire, *Income Taxes on the Realization of Future Interests*, 31 *Yale L. Jour.* 367.

⁷¹*Lucas v. Alexander*, (C.C.A. 6th Cir. 1928) 27 F (2d) 237.

⁷²*United States v. Guinzburg*, (C.C.A. 2d Cir. 1921) 278 Fed. 363; *Saunders v. Comm'r of Int. Rev.*, (C.C.A. 3d Cir. 1928) 29 F (2d) 834.

⁷³(1921) 255 U. S. 527, 41 Sup. Ct. 390, 65 L. Ed. 758.

⁷⁴(1921) 255 U. S. 536, 41 Sup. Ct. 392, 65 L. Ed. 762.

therein occurring between the date the asset was acquired and March 1, 1913, at least so far as these are later disposed of by direct sale of the asset itself. If these cases be construed as indicating the limits of Congress' power, and there is some basis for such view, then the date of acquisition of an asset, if prior to March 1, 1913, becomes one of the significant dates in determining what comprises a taxpayer's capital for tax purposes.

The situation in regard to property acquired after March 1, 1913, offers little difficulty. It becomes a part of the taxpayer's capital when acquired even though acquired by a transaction that involved realizing income by such taxpayer, that is, realized income adds to the taxpayer's capital the amount realized. The mere conversion of capital without a realization of a gain by substituting one asset for another has no effect upon a person's capital, and the tax laws take no account of it. There are, however, some transactions that increase a person's net capital that do not under the law involve any acquisition of income by him. Some of these rest on express statutory provisions such as property acquired by gift, devise or bequest, others are based on the theory that they represent capital as distinguished from income transactions. In the cases discussed in the preceding paragraph acquisitions of property were held to be capital transactions because they involved merely conversions of what was the taxpayer's capital at some earlier date, in the case next to be considered the property acquired involved no such conversion of prior capital, but represented the acquisition of new and additional assets with no corresponding increase in liabilities of any character, at least if the Court's theory of the case be adopted. The facts of the case⁷⁵ were that the Cuban government had during the period from 1911 to 1916 granted an American corporation certain subsidies in land and money under contracts requiring it to construct and operate a railroad, and to perform certain transportation services for the government and in respect of certain other services at specified rates. The subsidies were carried in a suspense account until 1916 when they were transferred to surplus. The tax authorities treated these cash receipts as prepayments for services and includible in income for the years when received, the land subsidy was not thus included. The Court denied that they were either such prepayments or gifts, but constituted capital contribu-

⁷⁵*Edwards v. Cuba R. R.*, (1925) 268 U. S. 628, 45 Sup. Ct. 614, 69 L. Ed. 1124

tions to promote public interests and to be used for completing the road's construction. The reasons assigned were that they were intended to reimburse the company for its capital outlay, and that nothing indicated that they were to be used for dividends, interest or anything else properly chargeable against earnings. It may be quite true that the payments were intended to reimburse the company for its capital outlay, but the fact remains that at the close of the transaction the company still owned that capital and had the subsidy in addition. Presumably the company would in future years charge rates sufficient to take care through depreciation charges to be again reimbursed for its capital so far as others used it, and that its own net income for tax and other purposes would reflect those facts. The result would be that it would be allowed to convert tax free an amount of capital in excess of that contributed by itself, that is, in excess of the cost to it of that capital or of the March 1, 1913, value of its own capital contribution. This result, which amounts to a double reimbursement for its capital outlay, would have been avoided by treating the subsidies as income either in the years of their receipt or in some or all of the years of future operation. The only other way to avoid it would be to restrict future depreciation charges so as to prevent the recovery through rates of more than the cost or value of its own capital contribution. As to the argument that nothing indicated that they were to be used for dividends, interest or other charges against earnings, it is sufficient to state that the very fact that they were carried to surplus makes them available for dividends at once, and that the character of the disbursements to which assets may be applied is scarcely a test of the capital or income character of the transaction by which those assets were obtained. The further argument that they represented no gains from the use or operation of the road does not tend to prove the Court's conclusion unless income is restricted to receipts of that character, which is the whole point in issue. The case raises the whole problem of what constitutes a capital receipt. The substitution of one asset for another without gain is clearly such, so is the acquisition of additional assets so far as offset by a concurrent equivalent increase in liabilities. The crucial case is that in which additional assets are acquired with no change in liabilities. Here there is an increase in net assets actually realized, an actual net accretion to a person's economic power, a flow to him of goods equal to the whole value of the additional asset.

This would seem to be as clearly income as is the realization of capital gains which has been held to be such.⁷⁶ The fundamental fallacy that underlies the reasoning in *Edwards v Cuba R. R. Co.*, is that the character of a receipt is made to depend on its disposition rather than on the nature of the transaction in which received, as if the use of corporate net earnings to increase fixed plant could alter the income character of the transactions producing the net earnings. The decision would be explicable had the Court adopted the view that it was a gift and thus not taxable under the statute, at least as concerns the subsidies received after March 1, 1913, or if treated as involving the concurrent assumption of a liability to perform its promises contained in the subsidy contract which was not evaluated in terms of money because of difficulties in that process, although this would be substantially equivalent to treating the subsidies as prepayments for future services.

The logic of the position that the acquisition of additional assets with no increase in liabilities due thereto produces income leads to the conclusion that gifts, bequests and devises are income to the recipient, however much they may from the general social point of view represent mere redistributions of capital. Since the legal concept of income is an individual income concept, the latter consideration would be immaterial. The tax law in fact excludes such acquisitions. Whether their specific exclusion indicates a legislative view that they would otherwise be includible in income is not the point of present interest, that point is whether they could be so included. If a gift is a capital transaction of the same order as the subsidies in *Edwards v Cuba R. R. Co.*, then the capital received thereby is the value of the asset at the time it is received. If so, then the sale of that asset at a price equal to that value would involve a conversion of capital without gain, and a sale for more than such value would involve conversion at a gain equal to the difference between the selling price and the capital value at the time of its receipt. It has already been shown that the capital value of an asset at March 1, 1913, is permitted to be recovered tax free on the subsequent sale of that asset, and that the principle on which that holding was based has its roots in constitutional theory. The capital value at the date a gift is received is not required to be thus protected. To compute the

⁷⁶*Merchant's Loan & Tr. Co. v. Smietanka*, (1921) 255 U. S. 509, 41 Sup. Ct. 386, 65 L..Ed. 751.

gain on its sale by a formula that treats as part of the donee's income a part of that capital value has been held not to involve a tax on capital but on income which need not conform to the apportionment rule.⁷⁷ The theory that it involved a direct tax on capital is forcibly argued in the dissenting opinion in the case while in the circuit court of appeals.⁷⁸ That is clearly its economic effect if a gift of property, as distinct from a gift of future income therefrom, is a capital transaction. If, however, the original gift of the corpus be itself income, then the existing rule for measuring the gain on the sale of property acquired by gift after December 31, 1920, whose validity was in question in *Taft v. Bowers*, takes on a quite different aspect. Its effect is then to tax at the time of sale the realized gain accrued during the donee's ownership, and to impose a deferred tax on a part of the income acquired by the donee at the time of the gift. To determine whether this theory accords with the Court's requires a statement of the reasoning in *Taft v. Bowers*. The principal point in it is that there had been but a single investment in the property sold by the donee, the investment by the donor. The donor held this investment subject to a liability to be taxed on the gain from its sale if he sold it, and the donee acquired it subject to that liability, that is, the liability to be taxed on its sale by him on the theory that it was being sold by the donor. To compute the tax on that basis thus constitutes the mere discharge by the donee of an obligation to the government voluntarily assumed at the time he acquired the gift, an approach to the problem of income that has possibilities limited only by judicial self-limitation. A situation is conceivable in which the negative value of that liability would reduce the capital value of the gift at the time of its receipt to the loss and gain basis the property would have if disposed of by the donor, but it is one that would seldom exist and which did not exist in *Taft v. Bowers*. That reasoning does not, therefore, dispose of the view that the rule of that case involves the taxation of capital if a gift of a corpus is a capital as distinct from an income transaction. The Court further affirms that nothing in the constitution requires income from capital gains to be restricted to gains occurring while the taxpayer owned the property. It is certain that the Court would so restrict it had it been acquired by purchase, which tends to the view that in

⁷⁷*Taft v. Bowers*, (1929) 49 Sup. Ct. 199.

⁷⁸(C.C.A. 2d Cir. 1927) 20 F (2d) 561.

the case of property other than that owned at March 1, 1913, the capital value protected against being treated as income on the conversion of assets is investment.⁷⁹ If so, the whole selling price on the sale of property acquired by gift could be taxed, if so, then it is difficult to see why the gift could not be treated as income when received. There is no logical basis for holding that the investment which is protected in the manner above described is that of some person other than the one making the investment, especially since the constitution clearly permits the adoption of the individual income concept. It must, however, be admitted that the reasoning in *Taft v Bowers* throws no light on what the Court would hold if gifts were sought to be taxed as income, or if their whole selling price were sought to be treated as gain, assuming in each case a gift made after March 1, 1913.⁸⁰

Gifts of the corpus of property are legally distinguished from gifts of income from the corpus. A gift of the latter as income has been held taxable.⁸¹ If the gift is one of future income, or of a series of future incomes, it would of course be possible to capitalize it. The question then arises whether such capitalized value is such capital as is protected against taxation on its conversion, that is, on receipt of the periodical income payments. The question would arise, as it has, in determining the recipient's right to deduct from each annual payment the diminution in the capital value due to the lapse of time. That such diminution occurs is an economic fact, and will remain so as long as interest exists. The right to such deduction has been disallowed on the score that there was no diminution by use in the value of the property producing the income, and that to permit it would encourage subterfuges to defeat the tax.⁸² The former reason is inadequate for it overlooks the fact that the interest of the

⁷⁹That the various tax acts are construed to protect that, see *Warner v. Walsh*, (C.C.A. 2d Cir. 1926) 15 F (2d) 367; *United States v. Bolster*, (C.C.A. 1st Cir. 1928) 26 F (2d) 760; *Allen v. Brandeis*, (C.C.A. 8th Cir. 1928) 29 F (2d) 363.

⁸⁰Another situation raising the problem of the extent of the protection accorded capital value against being treated as income on the conversion of that capital is that in which a person sells property bought at a forced sale at a figure below its actual value at the time of its purchase.

⁸¹*Irwin v. Gavit*, (1925) 268 U. S. 161, 45 Sup. Ct. 475, 69 L. Ed. 897 see for discussion of this type of problem, J. M. Maguire, *Capitalization of Periodical Payments by Gift*, 34 Harv. L. Rev. 20.

⁸²*Codman v. Miles*, (C.C.A. 4th Cir. 1928) 28 F (2d) 823.

person entitled to the income is itself a distinct thing. The rule of that case has received, and now has, statutory sanction. If the claim to those future payments had been purchased, the investment would be recoverable without being treated as income either by treating no receipt as income till the whole investment had been recovered,⁸³ or by treating a part of each payment as a return of capital. Here again it is the investment, rather than the economic capitalized value of gratuitous income payments, that receives protection. The capitalized value of those gifts of future income is in the economic sense those gifts themselves at the time the right therein is conferred. If that value need not be accorded freedom from taxes when periodically converted, there would seem to be no economic or legal reason why the gift of the corpus of property should be constitutionally incapable of being deemed income. It cannot be safely predicted that this would be the decision if the case were squarely raised.

The preceding discussion has aimed to set forth the elements in the concept of income that has been developed by the courts in dealing with income tax questions. It has been possible in some respects to indicate the constitutionally requisite elements, in others merely those developed in the process of statutory interpretation. It is probably, although not absolutely, correct to treat the latter as indicating elements that lie within the limits of the constitutionally permissible, but, since the statutes may have failed to include the whole field of permissible income, decisions excluding certain items from income on the basis of statutory construction cannot be taken as defining what cannot be income under the sixteenth amendment. A summary of the discussion, to be useful, would have to be too extended, and will, therefore, be omitted. The aim has been to outline the concept, indicate elements of inconsistency in it that come to the surface in various decisions and in the reasoning by which they are supported, and develop the implications of various of the judicial theories of income and capital. Emphasis has centered on that part of the reasoning in which the courts themselves have invoked economic considerations, and which might, therefore, fairly be subjected to an economic critique. Arguments such as that in *United States v. Phellis* that a stockholder receiving a dividend for which he has paid in his purchase price may be taxed when he receives that dividend because he steps into his predecessor's shoes, the some-

⁸³See cases in footnote 79.

what similar argument in *Taft v Bowers*, and that justifying certain rules because of their tendency to prevent tax evasion, have sometimes been stated, seldom extensively discussed, and even more rarely evaluated. The same is true of arguments based on the assumption that the courts were discovering the meaning of income as commonly understood, which finds its extreme formulation in the dissenting opinion of Mr. Justice Holmes in the *Stock Dividend Case*. The subordination of that kind of argument and type of consideration was not based on any theory that they were irrelevant, but rather that their use involves such broad reliance on almost immeasurable factors that enter into judicial discretion as to make their evaluation an extremely uncertain process. It is the creative judicial process in developing the concept of income for income tax purposes as that was influenced by economic considerations that has furnished the theme for this discussion. The courts have acted wisely in taking them into account and in giving them the weight they have received, too wide a departure therefrom might entail more injustice than it would eliminate.⁸⁴

⁸⁴See R. M. Haig, *The Federal Income Tax*.